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Bring on the Recession

It's the Best Time to Strengthen Your Strategic Position

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Many senior managers, especially in North America, have little or no experience steering their firms through a recession. So when the next recession arrives, they're likely to react instinctively and hunker down with fixed cuts across the board. If you're lucky, that's what your competitors will do.

Smart managers, by contrast, use recessions as a time to trade up. They "cut 2 and invest 1," cutting selectively and investing to build their next business design. Economic downturns offer a unique opportunity to accelerate that transition and dramatically improve your relative strategic position.

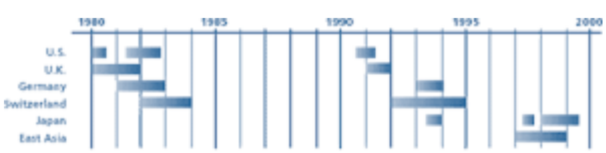
A recession is always under way somewhere around the globe. If the next one should arrive in your backyard, are you ready?Your financial house must be in order, of course. But to be really prepared, you must know what your business design should be after the downturn ends. If you know where you want to go and how to get there, a recession is by far the best time to improve your relative strategic position.

The first challenge managers face in a recession is uncertainty. No one knows how long the downturn will last, how deep it will be, or how quickly the strategic landscape will shift in the interim. (Since the end of World War II, U. S. recessions have lasted from 6 to 16 months, with real output falling from 0. 5% to 2% versus a normal 3% to 4.5% increase per year.) When a recession strikes, managers must quickly address the tough conditions it brings. They must also prepare for the rebound, which could arrive in 6 months.

But because most managers have little experience steering their firms through a recession, they instinctively reach for the lever marked "10% across-the-board cut" and hunker down. They order layoffs, hoard cash, delay product development, and wait for tough times to end. They address the recession but they don't prepare for the rebound. If you are lucky, that's what your competitors will do.

Great business leaders, by contrast, use recessions to capture the strategic high ground. In the 1990-91 downturn, for example, Michael Dell perfected his company's telephone ordering and demand-pull production system. At Intel, CEO Andy Grove accelerated investments in cutting-edge plant and equipment and launched the "Intel Inside" brand-building campaign. Both companies then powered out of the recession and have since captured the bulk of the profits earned in their respective industries.

Exhibit 1: Recessions occur frequently in the global economy.

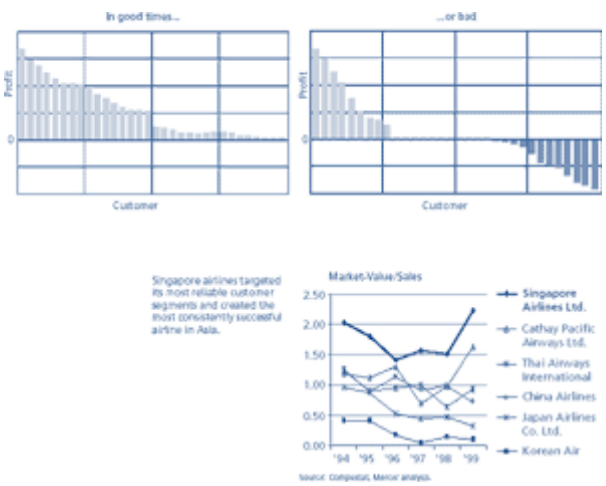


The key lesson: Start preparing now. Plan to accelerate your transition to your next business design. Before you're boxed in by deteriorating economic conditions, act on several fronts.

Become indispensable to your best customers

Before you pick up the hatchet, assess your customers. Identify the long-term profitability of serving each market segment. Should a recession hit, your best customers typically provide an even greater share of your profits, while your worst customers typically become value destroyers. So cull your portfolio of customers and cut out your weakest market segments. At the same time, redesign your value propositions to better serve your most profitable customers. Focus especially on opportunities to improve their economics. Then, make sure to deliver what you promise. Every customer contact is a "moment of truth" that should affirm your value proposition and build a consistent customer experience.

Exhibit 2: Not all customer segments are equally profitable.



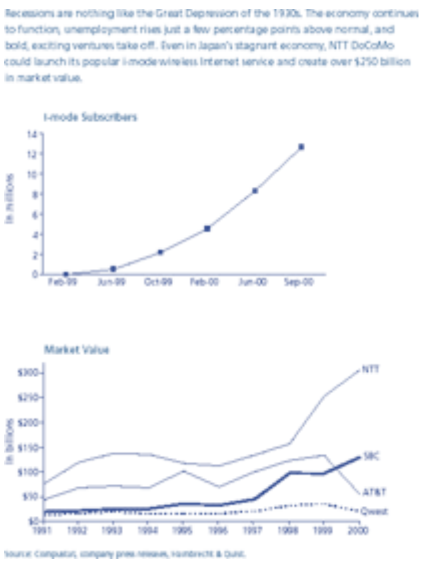
Singapore Airlines provides a classic example. A customer audit identified the company's most profitable customers, in good times and bad, as full-fare business and first-class travelers on transcontinental routes. The company responded by culling its customer base and focusing intently on serving these customers. It shifted capacity from short-haul to long-haul routes and "up-scaled" its value proposition. It invested $300 million in seat comfort, entertainment systems, meals, flight attendant training, and other improvements to first-and business-class service. Because of these moves, Singapore Airlines maintained its unbroken record of profitability right through the East Asian recession that followed the 1997 currency crisis. Its business has been far more successful than that of other Asian airlines, as indicated by its much higher market-value-to-sales ratio.

If your customers are companies, treat them in much the same way. Identify your best customers and kill them with kindness. Ease payment terms or lend staff to help solve their most pressing problems. Adjust your offer. Perhaps a customer would like to outsource a costly non-core function. Use a recession to expand your relationships, tighten your control, and reinforce your status as the supplier of choice. Businesses, however, often consolidate in a downturn. So do one thing right away: Identify the potential winners in those mergers, and strengthen your position with those firms.

Be sure to assess your customers for long-term profitability. Your best customers today might not be the best during or after a recession. Certain credit card companies such as Capital One, for example, reap high profits from customers who carry a substantial balance from month to month. Will a downturn push many of these customers into default? Should a credit card provider offer help by easing payment terms? Such companies must protect themselves against losses during a recession and emerge with the best possible portfolio of customers.

A final reason to focus on your customers first: They are your key to long-term success. To build a business design that will be viable after a recession, know your customers' priorities and where they are heading. DoCoMo, a subsidiary of NTT in Japan, acquired a deep understanding of what customers wanted when it created and nurtured its i-mode wireless Internet service. DoCoMo recognized a vast untapped market in teenagers who wanted chat, e-mail, and simple information services. It put together a value proposition that spoke to teenagers' priorities—fashion and inexpensive entertainment, not cutting-edge technology. Even though launched in the midst of Japan's prolonged economic slump, DoCoMo has been hugely successful. It created $250 billion in market value in Japan and is using this value to buy stakes in companies abroad.

Exhibit 3: Recessions do not shut the door to growth, as NTT DoCoMo shows.



Let "cut 2, invest 1" be your guiding principle

Cut 2: Once you know the customers you intend to serve and the value propositions you intend to offer, focus on costs. But avoid the traditional across-the-board cut. If you trim the wrong 10%, you could destroy 100% of the firm's value proposition. If Singapore Airlines had cut expenditures on customer service instead of spending more, it would have undermined its entire recession-ready business design. Eliminate expenditures that support customers and value propositions you intend to abandon, and ask whether the customers you intend to serve must pay for a particular item.

Recessions put a premium on efficiency. So use your cost engineering skills to cut overhead and to tighten up on inventories and receivables. As most companies already operate lean production systems, you will probably need to take more significant steps to get your costs in line. Now could be the time to install a digital production-control system. Beyond that, approach your suppliers. Explore opportunities to restructure the supply chain to lower everyone's costs. And the best time to get your house in order is before the economy turns down.

In 1998, when times were good, a large European building materials supplier decided to protect itself against potential economic threats by engineering a more flexible cost structure. It resolved to reduce fixed costs by at least 10%, lower its fixed-cost-to-revenue ratio, and outsource non-core functions. The company did not impose an across-the-board cut. Instead, it took a measured approach, using internal and external benchmarking and its understanding of the 15 European markets it serves. In four months, it identified reductions equal to 14% of total fixed costs. The cuts were differentiated by country and function and ranged from sales force and capacity consolidations to outsourcing support services. The company realized these savings by the end of 1999, making it well positioned to weather an economic downturn.

Exhibit 4: Quickly size up your situation by asking four critical questions.

1. How sound are my finances?
   Can I improve my:
   - Fixed vs. variable cost mix?
   - Level of working capital?
   - Debt levels, credit status, and cash reserves?
2. What is my position in the industry. Am I #1 or #2?
3. How resilient are my relationships with customers and suppliers?
   - How loyal are my customers and suppliers?
   - How exposed are my customers and suppliers?
   - Which customers or suppliers might consolidate?
4. How vulnerable are my competitors?

Controlling inventories and receivables is critical. Both are expensive to carry. Inventories lose value. And receivables might never get paid. So sharpen up your production and logistics management skills. You should be able to accelerate the payables-inventory-receivables cycle, slash inventories and receivables, and reduce your working capital needs.

Be sure to consider digital demand-pull production systems. This technology is now well-proven, and even small-scale systems can have a rapid payback. Weyerhaeuser installed such a system in 1995 at its custom-door-building plant in Marshfield, Wisconsin. Using a Choiceboard® system, configuring and ordering products went from a cumbersome three-week process to a 15-minute session on the Web. The integrated digital production system then cut manufacturing time in half, slashed inventories, and delivered nearly all orders on time. In addition to cutting working capital, the speed and reliability the new system provides have become critical components in Weyerhaeuser's value proposition. Its doors now command a premium price, unit volume has doubled, and return on assets has reached 27%.

A Recession-Ready Business Design

Now is the time to recalibrate your business design to prepare for the next recession. Review the standard playbook. Examine the latest digital options. Do what you must now, and be prepared to act quickly should the economy worsen.

It's actually easier to reconfigure your company in a slowdown. You're not growing at breakneck speed. You've got your employees' undivided attention, and they understand that the company must adjust to the new environment. Your competitors, in addition, may be "hunkering down."

If you make the right moves, you should rebound from a downturn sooner, stronger, and with a markedly improved strategic position.

[View Table of Business Design Elements]

If your company has sophisticated digital systems in place, you might find little fat to cut in your production process. You must then take a broader view of your expense structure. Approach key suppliers and ask what could be done to get your costs down. Could they use your expertise in cost engineering? If you outsource a function, could they do the work more efficiently? Cisco, for example, uses contract manufacturers to build and ship directly to its customers fully 60% of all units produced. If a supplier needs to get bigger to capture an economy of scale, could a loan or long-term contract help finance a needed acquisition? The more you rely on outside suppliers, the more you must look beyond your own organization to get your costs in line.

But remember, cost-cutting alone is no formula for victory. Oliver Wyman analyzed the strategies and performance of 800 companies in numerous industries during the period 1987-1992, which included the last recession, and identified 120 "cost-cutters." Of those firms, only one in three achieved profitable revenue growth during the five years that followed. To set the stage for growth, cuts must be selective and based on an understanding of where value within the company resides, both now and in the future. To capture that growth, you must invest as well as cut.

Invest 1: Recessions make the impossible dramatically possible. If you know what your company needs to succeed tomorrow, a recession is the best time to buy or build those assets. It's easier to move upstream or downstream, develop a killer product, or acquire a critical customer-service capability. Talent unavailable today gets freed up in a downturn, and your current employees also have an added incentive to upgrade their skill sets.

Most valuable are moves that strengthen your competitive position, such as those made by Intel and Dell in the 1990-91 downturn. These companies understood the rewards as well as the risks. They knew where they were going, saw a clear path to get there, and had the fortitude to move forward. Andy Grove, Intel's CEO at the time, summed it up: "For us to have the opportunities that we have today and not bet on them, I don't want to lose that way."

Intel and Dell had a solid strategic position going into the last recession. But firms in far weaker positions can also get stronger. Take Hongkong Telecom. In October 1997, the company faced an uncertain future. The deregulation of its core long-distance telephone business meant that competition would soon drive prices to unattractive levels. Then the Hang Seng Index crashed and the East Asian recession arrived in Hong Kong. HKT already had targeted several adjacent and potentially more profitable businesses to enter. Thanks to the downturn, it could go shopping for assets when prices were right. In January 1998, Hongkong Telecom acquired Pacific Link Telecommunications, a competing wireless operator. It relaunched the business in May as a low-end offering for the growing price-sensitive customer segment—and to complement the firm's existing high-end wireless service. HKT also acquired Star Internet, the number two provider in the market, in 1998. Both acquisitions expanded the firm's customer base and strengthened its strategic control over profit streams in rapidly growing businesses. Because it could make these moves in a recession, the company sharply improved its prospects at bargain-basement prices.

Accelerate the digital transition

The digital business revolution has paused for a moment. The dot-com bubble has burst. Traditional firms are awash with scattered, sub-scale, and overlapping e-business initiatives that have yet to add value. Many managers at these large corporations have taken this as a sign to relax and cut back. If a recession hits, the "hunker down" mentality would further slow their digital transition.

So no matter where you stand in the digital business revolution, the next few quarters will provide unique opportunities. Talent and other resources should be relatively abundant and your competitors inattentive.

If you're just beginning the shift to digital business, now is the time to catch up. Cisco, Dell, Cemex, and a handful of other digital pioneers achieved productivity and profitability gains that have placed them far ahead of their competitors. Their techniques have been well developed, so you don't have to reinvent the wheel to digitize. Just be sure to manage the process in a business-like fashion. Focus on your most pressing business issues, not the technology. Be sure to measure progress as you would with any investment—with a market-value yardstick.

This is precisely what many large corporations have not done. While dot-com hysteria raged in the financial markets, these companies each spawned hundreds of e-business initiatives. Most cost between $.5 million and $5 million—a small sum when compared to the average IPO. But most of these intrapreneurial ventures are still alive and kicking and requesting more capital. In the aggregate, they probably represent more wasted investment than the far more visible dot-com fiasco. It's now time to bring order out of this chaos. Assess what you need, define what you've got, then draw up a plan. Cut 2, invest 1. And by the end of the slowdown, have sound digital business designs in place.

If you already have a solid digital infrastructure, business intelligence systems are the most promising new opportunity. They analyze the enormous flows of data, and move your business from judgment-driven to information-driven decisions. These systems are especially attractive in recessions. They can generate significant returns from small incremental investments. They also are especially good at responding to shifting customer priorities—and customer priorities shift quickly in a downturn.

A regional supermarket chain added margin engineering—one such business intelligence system—to its existing digital infrastructure. It took a few years and several million dollars to build. But the company can now predict the impact of price changes and promotions on storewide profitability. To maximize profits, it raised some prices and lowered others. Sometimes it captured profits not primarily on the item in question, but on items purchased in tandem. The payback has been dramatic. By the third year of operation, the investment yielded over $100 million in additional gross margin. The company also added a system to predict the profit impact of floor-space allocations and changes in the variety of brands or package sizes, which further contributes to storewide profitability.

Exhibit 5: Business intelligence systems, the next step in digital business design.

Crayola used another business intelligence system, scientific online experimentation, to significantly improve the performance of its Web site. Customer response to Web-marketing initiatives is notoriously poor. The judgment that marketing professionals have developed in other media—on matters such as when to quote a price or offer a discount—is of little use. So Crayola used online experimentation to guide its marketing decisions. It tested and optimized e-mail solicitations, banner ads, and Web site value propositions. The best treatments were nearly four times as effective in converting shoppers into buyers, nearly doubled revenues per buyer, and added significant profit.

Secure financing

Funds are still plentiful. But once a recession starts, the spigot might be suddenly shut off, as was the case during the last recession's "credit crunch." So line up your financing now, and minimize working capital by allocating it only to the most important projects.

Hutchison Whampoa, a conglomerate based in Hong Kong, issued $2 billion in bonds during

July 1997, three months before the stock market crash. Demand for the offer was far higher than the target amount, and the average cost of the loan is substantially lower than most other deals of comparable size and duration today. Because of the subsequent financial crisis and credit crunch, Hutchison was among the few companies in the region with enough cash to take advantage of cheaper land and assets. It invested the capital in wireless services and equipment, hotels, and ports in several countries.

Get the story out

Executing these strategies isn't enough. You must also make sure that the people who matter understand what you're doing and why. Market your message internally: Tell your employees your firm's recession-ready strategy—a strategy based on the realities of the marketplace. If you are shifting your business design, show how you will realign incentive structures and reporting systems. This helps maintain loyalty and morale, and increases the acceptance of cuts and new strategic initiatives.

And get your story out to lenders and investors. If they are informed, they will have a better basis for making decisions that can support you and your business.

Great managers embrace recessions because of the opportunities they present. They appreciate the competitive risk of not investing when the moment is right. Timing, therefore, is important. So make the right moves during this pre-recession period. You will then be prepared not just to weather a recession, but to emerge in a far stronger strategic position.

Slywotzky is co-author of *How Digital Is Your Business?* (Crown Business, 2000)